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Tax Treatment of ETFs and Mutual Funds for Non-Registered Accounts

Exchange-traded funds (ETFs) and mutual funds have become such popular investment vehicles that it is important to be familiar with the tax issues surrounding these types of funds when they are held in your non-registered accounts.

In general, there are two situations that would require you to report information in your annual income tax return: i) when a fund makes a distribution in the year; and/or, ii) when you dispose of all, or some, of your holdings in the fund.

Distributions

At the end of every calendar year in which it made a distribution, a fund is required to issue a tax reporting form. This tax slip will indicate the amount and nature of the distributions that you received.

The types of distributions that are included in your taxable income may consist of: dividends (eligible and/or those dividends other than eligible), capital gains, other income (which generally represents interest, rental, and/or business income) and foreign income.

The type of tax slip issued may vary. For example, if you own units of a mutual fund trust, you will receive a T3 slip — *Statement of Trust Income Allocations and Designations*. If you own shares of a mutual fund corporation or an exchange-traded fund, you will receive a T5 slip — *Statement of Investment Income*.

The tax slip should also indicate the amount, if any, of the distributions that are to be considered a return of capital. Although a return of capital is not subject to tax when received, it does have a tax implications in the future.

It is important to recognize that distributions by a fund can be made in cash and/or through a non-cash reinvestment in the fund. If a fund makes a non-cash distribution, you would still include the taxable components of the distributions in your income for the year. However, you would also add the reinvested amounts to your adjusted cost base ("ACB") in the fund, as explained in the next section.

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Note that the structural differences between ETFs and traditional mutual funds can affect capital gains, as ETF sponsors do not need to sell underlying securities to raise cash for redemptions (instead, an exchange occurs, which is not considered a taxable event). This may reduce the likelihood of incurring capital gains.

Disposition

The disposition of a fund must be reported in your tax return in the year that it is sold. The calculation of the capital gain or loss resulting from the sale is determined by taking the net proceeds received after commissions or fees and subtracting the ACB of the fund sold.

The ACB of the fund is composed of the following amounts, if any: i) the total amount that you paid to buy the fund, including commissions; ii) plus the amount of all non-cash reinvested distributions; iii) less the return of the capital component of any distributions; and, iv) less the ACB of any previously sold shares or units.

It is important to maintain detailed records of your investments in order to calculate the ACB of a fund, particularly in situations where you are selling only a portion of your holdings, there have been returns of capital, and/or there have been reinvestments in the fund.

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